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SUBJECT: Can the Netherlands Overcome Dutch Disease?

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THE HAGUE 00000449 001.2 OF 004

¶1. (U) SUMMARY: The recent OECD study 'Going for Growth' emphasized the growing gap in national income between the U.S. and the countries of Europe. The study argues that European countries have done too little to boost productivity or strengthen work incentives, thus maintaining high implicit taxes on labor. In the Netherlands, which suffers from many of the rigidities noted by the OECD, the government has worked hard to implement a broad range of structural reforms over the last two years. But independent experts of the Dutch economy question whether these reforms have been effective and sufficient in dealing with the country's larger challenges. Specifically, they contend, the Netherlands needs stronger competition among Dutch companies as well as among Dutch workers, requiring structural reforms of product markets as well as of the labor market. It also needs to drive the workforce into knowledge intensive services and invest more in their skills. These challenges will need to be addressed at the political as well as at the individual level. Politicians will need to get outsiders back into the game, while the workforce will need to play harder. The Dutch have always been competitive abroad, but will now have to start competing at home, both with themselves and with newcomers.
END SUMMARY

Going for Growth

¶2. (U) The welfare states of Europe are bracing themselves for the impact of globalization and population aging. The challenge is clear, but structural reforms are only slowly being implemented. In early 2005, the OECD published 'Going for Growth,' the first edition of what was intended as an annual survey and scorecard of member states' structural inhibitions and policy reforms. That study, the second edition of which was released on February 7, noted the growing per capita income gap between the U.S. and the OECD's other members and prescribed specific structural reforms to boost each member state's labor input and labor

productivity. In the Dutch case, the OECD recommended changes in residential zoning laws to improve labor mobility and reform of the Netherlands' disability and general welfare systems to improve work incentives. To boost productivity, the OECD economists suggested changes in land-use laws and reduced barriers to foreign ownership, both of which were intended to facilitate the entry of new firms and thus encourage competition, particularly in utilities and retail distribution. (See www.oecd.org/growth/GoingForGrowth2006 for the updated assessment of individual OECD members' structural reforms; ref A summarizes the latest OECD review of the Dutch economy.)

¶3. (U) The Dutch government, in the third year of its four-year (2003-2007) parliamentary term, is hoping to reap the benefits of structural reforms implemented over the past two years (see ref B). After performing exceptionally well in the 1990s, the Dutch economy has struggled since 2001, with growth averaging less than one percent per year. After five slow years, growth in 2006 is expected to accelerate (ref C), with forecasts ranging between 2 and 2.75 percent. But while growth is expected to pick up in the Netherlands this year, several structural problems remain. To assess the prospects for structural reform and to judge whether this year's pickup in growth is sustainable, Econoffs recently met separately with four leading university professors: Jules Theeuwes, Joop Hartog, Bas Jacobs, and Ruud de Mooij (affiliations noted in paragraph 12 below). All agreed that recent reforms have been necessary, but also that further changes are called for to transform the Netherlands into a knowledge-based economy ready to meet the challenges of globalization and aging.

Background: From star to laggard

¶4. (U) The period of high growth in the Netherlands in the

1990s is often referred to as the Dutch miracle. This 'miracle' was the result of increased flexibility in labor contracts and of an increasing number of women entering the labor market. Following this period of high growth, the Dutch economy ground to a halt in the early 2000s. This slowdown started when house prices stopped rising and share prices fell. As in the U.S. more recently, rising house prices were a source of additional purchasing power in the 1990s. This stimulus to demand dried up after 2000, however, when prices plateaued. Falling share prices caused increases in pension premiums to compensate for the worsened financial position of the Dutch pension funds. The required premium hikes increased labor costs for employers while at the same time decreasing disposable income for workers.

¶5. (U) Rather than increase government spending to boost the economy, the GONL responded with spending cuts intended to bring the fiscal deficit back within the three percent of GDP Maastricht ceiling. (In fact, the thanks to spending restraint and the extra revenue from higher natural gas prices, the deficit fell from 3.2 percent in 2003 to 0.5 percent last year.) In addition, the government decided on a package of structural reforms aimed at increasing labor market participation and improving the economy's overall performance. Over the past two years, the government has reformed unemployment insurance, disability insurance, health insurance, and has ended early retirement schemes. The government sees the next two years as the time when it will reap the economic benefits of these structural reforms, hoping that people will vote with their wallets in this year's municipal elections and next year's national elections. After slow growth in the past two years, the economy is expected to be back on track in 2006 (ref C). Official estimates for 2006 have growth somewhere between 2 and 2.75 percent. (The IMF estimates it at 2.0 percent, the OECD at 2.2 percent, while more recent local estimates by

the Central Bank (DNB) and the Dutch Bureau for Economic Policy Analysis (CPB) place it at 2.5 and 2.75 percent respectively, slightly higher than the euro zone average.)

Academics question reforms' effectiveness

¶6. (U) Academic experts interviewed by Econoffs question whether this improvement can be attributed to government reforms. They point to the fact that these reforms are to a large extent being undermined by recent collective wage agreements. (Although no longer required by law, employers and employees agree on contractual terms equally favorable as before the reforms.) This does not only undermine the effectiveness of government policy, it also creates a further break between those in the labor market and those outside trying to get in. The increased flexibility that allowed the economy to grow in the nineties was the result of employing additional workers through flexible, temporary contracts. As Bas Jacobs points out, permanent jobs continued to be protected. The flexible workers that fueled the growth of the nineties were also the ones who lost their jobs at the downturn. (Note: Among the workers hardest hit by this downturn in the labor market were members of ethnic minorities, whose unemployment rate has more than doubled since 2001. See refs D and E.) Employers and employees with long-term contracts are now undoing government efforts to further increase labor market flexibility at the negotiating table, thereby reducing the possibilities for newcomers to compete for jobs.

¶7. (U) The labor market is not the only market that could do with more competition. Competition policy in the Netherlands is still at an early stage. Bas Jacobs stressed that many product markets and, more importantly, services remain uncontested. Interestingly, although overall Dutch productivity, measured on a per hour basis, is comparable to that in the U.S., productivity levels are especially low in the sectors where the Netherlands' large multinational companies are most active: banking (ABN AMRO), insurance (Aegon), retail (Albert Heijn), wholesale (Unilever). At the national level, these companies do not have enough competition. In addition, the manufacturing sector is still the main exporter and the services sector is only slowly taking over this role, noted Jules Theeuwes.

The 'Polder Model' - Help or Hindrance?

¶8. (U) The experts disagreed sharply among themselves as to whether the Netherlands' famed 'polder model' of intensive consultation and negotiation among stakeholders was a help or a hindrance towards fostering a more dynamic and flexible economic system. Those who believed that the Dutch economy does in fact respond well to market pressures saw such consensus-building among 'social partners' as an effective method of lubricating the adjustment process and, minimizing the strikes and other conflicts that have stalled reform elsewhere. Those who instead emphasized the Dutch economy's rigidities thought that such negotiations would inevitably protect the interests of established insiders -- i.e., those at the table -- while shortchanging the needs of the unrepresented, such as new immigrants or potentially disruptive entrepreneurs. They saw the Prime Minister's 'Innovation Platform' -- a committee consisting of the Netherlands' business and academic elite -- as doomed to failure, since the leaders of such established organizations would never favor policies that would facilitate the emergence of a Google or a Ryanair.

Dutch labor market - how flexible?

¶9. (U) Low productivity levels are a problem for a country

that needs to shift towards exporting knowledge intensive services. A rigid labor market is another. Joop Hartog claimed that the economy may be rigid in terms of hiring and firing, but not in a structural sense. A shortage of labor in one sector can simply be overcome by making jobs more attractive. The Dutch economy has demonstrated this type of flexibility before when a great many teachers were required to educate the large baby boom generation. A larger problem, however, is the demographic situation. There are not many workers coming just out of school, so it will be those in the labor market that will have to change and learn new skills. This is a problem that will grow as the population gets older. Ruud de Mooij emphasized the importance of this problem by noting that the labor market for older workers is the most rigid. Collective wage agreements define minimal salaries that go up with age. While productivity tends to go down with age, salaries go up. The result is that older workers have little wage flexibility and are overpaid given their productivity. And, after a certain age, it becomes impossible for workers to re-enter the job market after losing a job. This is another example of insiders protecting their vested interests against outsiders trying to get (back) in.

¶10. (U) The shift towards a knowledge intensive economy also requires high investment in education. Ruud de Mooij raised this as an immediate problem. With one of the highest employment ratios in the OECD already, the economy needs innovation to grow. But how should the traditionally egalitarian Netherlands optimize its investment in human capital and knowledge creation? Should this money be invested in high-level education, or in bringing up the mean? The experts remain divided. Bas Jacobs said that the GONL should foster academic excellence and allow private investment in education. Joop Hartog, on the other hand, favored a broader approach, reasoning that a knowledge economy needs people to implement innovations and a well-organized labor force at all levels. The consensus is that, in the words of Jules Theeuwes, people should learn to invest in themselves rather than expect to be taken care of.

Housing as a labor market barrier

¶11. (U) In the medium term, the next big challenge will be the housing market. As noted earlier, house prices soared in the 1990s but have risen only modestly since. But the high cost of housing creates a barrier to relocating, which adds to inflexibility in the labor market, as noted by the OECD. Strict land use controls have limited new construction, thus helping to keep housing prices high. The high level of government sponsored mortgage loans not only raises house prices further, but also makes the Netherlands sensitive to shocks in financial markets. In addition, the deductibility of mortgage interest raises budget and equity concerns; it amounts to 10 percent of taxes, with expenses

primarily going to the rich.

¶12. BIO NOTE: Joop Hartog is a professor of economics and program director of human capital at the University of Amsterdam. Bas Jacobs is an assistant professor at the University of Amsterdam and at the University of Tilburg, and is also a researcher at the Netspar Institute for Savings, Pensions and Retirement. Ruud de Mooij is a professor of fiscal economics at the Erasmus University Rotterdam and is the program director for welfare state research at the Netherlands Bureau for Economic Policy Analysis. Jules Theeuwes is a professor of economics at the University of Amsterdam, managing director of the Economics Network for Competition and Regulation (Encore), and member of the Scientific Council for Government policy (WRR). END NOTE

Comment: Promoting competition at home to meet competition

from abroad
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¶13. (U) The Netherlands became a textbook example for development economics when it experienced the original case of 'Dutch disease.' Large-scale exports of natural gas caused a rising real exchange rate, leading to a loss of international competitiveness and providing the resources to fund an increasingly bloated welfare state. The Dutch 'miracle' of the 1990s led to a eurozone-era variant of the malady by the end of that decade, this time by pushing up real wages instead of the nominal exchange rate. Wage moderation in recent years has helped the Dutch economy to regain at least some of its competitive position. But in the globalized 'flat' world of the 21st century, competitiveness is far more a function of innovation and dynamic flexibility than of wage or price levels, especially for an advanced, post-industrial, service-dominated economy such as that of the Netherlands.

¶14. (U) Dutch political and economic leaders have put innovation at the top of their reform agenda, an agenda that may have gone as far as is politically feasible. But the Netherlands' disappointing productivity performance -- only 0.7 percent average annual growth since 1995, the second-lowest rate in the OECD (after Italy) -- suggests perhaps that its top-down, supply-driven approach to revitalizing its economy can only go so far. The Dutch have succeeded in expanding the knowledge base for innovation by subsidizing and promoting science, R and D, and education, but they have not sufficiently dismantled the industrial concentration and other protective traditions of the Netherlands' internal market. These traditions have softened the pressures on companies to innovate. Increasing competition at home -- and thus the demand for innovation -- may be the best way for the traditionally internationalist Dutch to meet the increased competitive challenge they face from abroad.

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